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Managing Editor

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STATE SOCIETY ACTIVITIES

Calendar of Events

October 5—Regular Meeting of the Board of Directors. 7:30 P. M. Subject: **Wartime Control of Prices.** Location: Waldorf-Astoria Hotel, Lexington Avenue and 49th Street, New York City.

October 19 and 20—Fourth Columbia Accounting Institute. Location: Hotel Pennsylvania, Seventh Avenue and 33rd Street, New York City.

November 5—Regular Meeting of the Board of Directors.

November 9—7:30 P. M. Society Meeting. Subject: **State Taxation.** Location: Waldorf-Astoria Hotel, Lexington Avenue and 49th Street, New York City.

Wartime Problems Release Release No. 18

On September 14, 1942, release No. 18 was sent to the entire membership. It dealt with the question of whether or not public accountants are covered by Selective Service Bulletin No. 10, published as Wartime Problems Release No. 14. The American Institute of Accountants wrote to the National Headquarters of Selective Service in order to clear up this question, and the reply they received is included in Release No. 18.

The Society's Committee on Wartime Problems believes "that only accountants essential to the war effort as outlined in Wartime Problems Release No. 4 should be considered for deferment and in the filing of Form 42-A (employer's request for occupational classification of a registrant), in the case of a public accountant there should be attached a detailed statement naming the clients for whom the registrant has been working, is working, and is expected to work, indicating those which are engaged in war production and those which are engaged in other activity essential to support of the war effort, and showing also the approximate time devoted by the registrant to the affairs of each client."

Committee Chairmen Dinner

On September 17, 1942, the chairmen of the Society's standing and technical committees met for dinner with the Board of Directors at the Waldorf-Astoria Hotel, New York City, with President Marvin presiding. The meeting was honored by a number of past presidents of the Society: Messrs. Robert H. Montgomery, Joseph J. Klein, P. W. R. Glover, Walter A. Staub, James F. Hughes, and A. S. Fedde. Also present at this dinner was Harry D. Anderson, President of the Syracuse Chapter.

President Marvin, after introducing the past presidents, the officers, and members of the Board, spoke briefly concerning the program of the Society for the ensuing year. Vice-Presidents Saul Levy and Henry A. Horne spoke of the work of the standing and technical committees respectively. Chairmen of the various technical committees were introduced, and general discussion of the problems before the Society followed.

Nominating Committee Elections

Messrs. Simon Loeb and Arthur H. Rosenkampff were elected at the October 5, 1942, Board of Directors meeting to serve on the Nominations Committee. The other seven members were elected at the May 11, 1942, Society meeting.

Taxation Meetings

The Committee on Meetings has changed the date of the annual Federal Taxation Meeting, normally held in November, to December 14, 1942, and advanced the State Taxation meeting, normally held in December, to November 9th. This change has been made due to the fact that the federal tax bill has, at this writing, not been passed, and it is felt desirable to give the Committee a greater opportunity to study the provisions of the Bill in order that they may be able to present a program of greater assistance to the members of the Society.

American Institute Elections

Officers, members of the council and auditors of the American Institute of Accountants, were elected at the fifty-fifth annual meeting of the Institute at Chicago. Those elected will serve the 1942-43 term.

Officers:

President—George S. Olive of Indianapolis, vice-president and chairman of the industrial commission of the Indianapolis Chamber of Commerce, and senior partner of the accounting firm of George S. Olive and Company.

Vice-Presidents—George P. Ellis of Chicago, past president of the Illinois Chamber of Commerce and partner in Wolf and Company.

Victor H. Stempf of New York, partner of Touche, Niven & Co., and past president of the National Association of Cost Accountants.

Treasurer—Samuel J. Broad of New York, partner of Peat, Marwick, Mitchell & Co. (reelected)

Secretary—John L. Carey of New York (reelected)

Members of council, each to serve a term of three years:

Albert J. Watson, San Francisco; J. B. Scholefield, Los Angeles; Arthur L. Baldwin, Denver; J. William Hope, Bridgeport, Conn.; Fred J. Duncombe, Chicago; William M. Madden, Indianapolis; Fred J. Peterson, Des Moines; Charles W. Hatter, Baltimore; Homer N. Sweet, Boston; Ernest H. Fletcher, Detroit; Earl A. Waldo, Minneapolis; Perry Barnes, Kansas City, Mo.; Warren W. Nissley, New York; Russell C. Harrington, Providence, R. I.; Hilary H. Osborn, Nashville, and Harry R. Howell, Charleston, W. Va.

Auditors:

Gordon M. Hill and Howard A. Withey, New York.

J. Arthur Marvin, President of the Society, was elected Chairman of the Advisory Council of State Society Presidents. Mr. Marvin succeeds Abner J. Starr, President of the Ohio Society, and is the second New York State Society president to be elected as Chairman of this important group, Morris C. Troper having served from 1935-1936.

Institute on Federal Taxes

New York University will sponsor an Institute on Federal Taxation from November 30 to December 11 to meet the needs of attorneys, accountants, corporate officials and trust officers whose work is largely concerned with tax matters, it has been announced by Paul A. McGhee, acting director of the Division of General Education.

Scheduled to meet for the ten-day session after the details of the new Federal tax law have been completed by Congress, the Tax Institute pro-

gram will be conducted by a Committee composed of J. K. Lasser, tax authority and lecturer in the Division of General Education; Dr. Rufus D. Smith, provost of New York University; Harry J. Rudick, lecturer on taxation at the University's School of Law, and Paul Studenski, professor of economics in the University's School of Commerce, Accounts, and Finance.

Sessions will be held afternoons during the ten-day period, leaving the mornings free for members to attend to personal and business matters during their stay in the city. Thirty nationally known authorities on Federal tax matters have accepted invitations to become discussion leaders and lecturers. Following the afternoon sessions, which will be devoted to formal presentations of special topics, the group will meet for dinner and informal discussion. Representatives of the Treasury Department are expected to attend the sessions to discuss current thinking of the Treasury on various technical matters.

The fall date of the Institute was selected so that those attending would have an opportunity to study the details of the 1942 tax law under expert leadership before they are called upon to advise clients and prepare corporate and estate returns based upon what is expected to be the most drastic piece of tax legislation ever enacted by Congress. The fact that over 7,000 attorneys and certified public accountants have been admitted to practice before the United States Board of Tax Appeals in recent years illustrates the growing importance of Federal tax litigation with the increasing complexity of each succeeding Federal tax law, according to Mr. McGhee. One of the purposes of the Institute is to assist attorneys and accountants, who have recently taken up this specialized work, to become familiar with current trends in tax matters.

Lecturers and discussion leaders follow:

Maurice Austin, George R. Blodgett, Edmond N. Cahn, Clarence Castimore, Alger B. Chapman, D. B. Chase, W. A. Cooper, John W. Drye, Jr., Peter Guy Evans, Ewing Everett, Samuel J. Foosaner, Kenneth W. Gemmill, Joseph A. Gerardi, Benjamin Grund, Sydney A. Gutkin, Leo H. Hoffman, J. K. Lasser, V. H. Maloney, Leo Mattersdorf, Charles Meyer, Max Rolnik, Nathan F. Ross, Harry J. Rudick, Isadore Sack, Paul D. Seghers, J. S. Seidman, Harry Silverson, Clarence L. Turner, Thomas M. Wilkins.

The tuition fee for the ten-day Institute will be fifty dollars payable in full at the time of registration. For further information write to Paul A. McGhee, New York University, 100 Washington Square, New York.

Francis P. Byerly

Francis P. Byerly of Price, Waterhouse & Co., and a Director of the Society since 1941, died at his home in Pennsylvania on September 4, 1942, at the age of 52. Mr. Byerly was admitted to membership in the Society in 1937, and since that time has served on numerous committees, and was Chairman of the Committee on Federal Taxation from 1938-1940. He was a C.P.A. of four other states.

The Board of Directors, at its regular meeting on September 17, 1942, adopted the following resolution on the death of Mr. Byerly:

"RESOLVED, That in the death of Francis P. Byerly, The New York State Society of Certified Public Accountants lost a loyal member who maintained a continuous membership in the Society for a period of five years and who served as a Director for one year.

"The Board of Directors of this Society hereby records its sorrow at the death of Mr. Byerly and its appreciation of his professional spirit and exemplary action in so faithfully serving the Society and his chosen profession.

"The Board of Directors directs that this resolution be incorporated in the minutes of its meeting and that a copy of it be sent to the family of Mr. Byerly."

Morris Pomerantz

Morris Pomerantz, a member of the Society since 1928, died on September 14, 1942. He is survived by his wife and two children.

Lloyd Birns

We have just been notified of the sudden death of Lloyd Birns on July 15, 1942. He was a member of the Society since 1939.

If you can't go

GIVE!

RED CROSS WAR FUND

Why a Corporation?

By BENJAMIN J. ELSON, C.P.A.

THE corporation has been traced as far back as 700 B. C. to the ancient Greeks and Romans. When the Romans conquered Britain, corporations were introduced by them into the British Isles. The English kings and parliaments created public and private corporations in dealing with the American colonies. After the revolution, the states of the United States and the Federal Government allowed the establishment of corporations for almost every legal, public and private purpose. As trade and commerce grew and prospered in this country the use of the corporate way of doing business became increasingly common. The main reason for the increase of incorporations was probably to enable stockholders to invest money without subjecting themselves to personal liability for the debts of a business venture.

In many cases today the limited liability resulting from operating as a corporation is more illusory than real. This is particularly true in closely owned corporations where creditors require the principal parties involved to personally guarantee the company's debts. In many cases the parties have their entire net worth invested in the corporation so that its failure would result in the loss of their entire capital even though they are not personally liable. The increasing use of insurance, some of it compulsory, has also tended to decrease the advantages of the corporate entity. Accountants and other business advisors who have done so much to encourage the incorporation of business enterprises may well pause and ask themselves today—"Why a Corporation?"

Of course, the most important point involved in deciding the advantages or disadvantages of the corporate way of doing business is the comparative tax cost as against operation by an individual or partnership. Somehow, today, all our discussions and problems invariably are decided by the tax costs involved. Without going into any specific figures it may be said that all the advantages are on the side of individual or partnership organizations. Corporations are subject to the normal tax and surtax, the excess profit and declared value excess profits taxes, the capital stock tax and the section 102 tax on Surplus. In addition to this we have the payroll taxes on officers' salaries, the state franchise tax and stock transfer taxes. After paying all these taxes the individuals involved have to pay individual income taxes on whatever sums they receive from the corporation as dividends or salary. In fact our present tax laws result in the double taxing of corporate income—once within the corporation itself and secondly outside of it at the time of distribution. I believe it is almost impossible to find a case under the present Revenue Act where operation by a corporation is less costly than partnership or individual operation from a tax viewpoint. I know of instances in which clients were told that it would be possible to save money by operating as a corporation and have examined figures which purported to bear out this contention. Upon analyzing the figures I found the "saving" was accomplished by piling up in "Surplus" profits which were withheld from the individuals. This practice may well lead to a day of

Presented at a special meeting of the Committee on Real Estate Accounting, May 28, 1942, at the Engineering Auditorium, New York City.

reckoning and with the constantly rising rates is likely to be costly. The argument that losses of subsequent years may wipe out the "Surplus" fails to consider the fact that in the case of personal operation, losses can be offset against other income of the taxpayer for that year.

Now I realize, of course, that we cannot by one fell swoop do away with all the corporations in the business world. For big enterprises they are probably indispensable. They are also necessary where ownership is divided among a great number of individuals. They are probably best suited in cases where investment is made by one who is inactive, especially where the risks are great and amounts involved are large. But I firmly believe that in many cases closely owned corporations of medium or small size could be dispensed with at great saving to their owners. More new enterprises should be unincorporated and many existing corporations could well change over to individual or partnership operation. In many cases the change over from corporation to partnership requires much thought as to the best method to be followed. There are many obstacles, taxwise. There must be a decision as to the proper way to dissolve or liquidate; whether to resort to a dividend in kind or to sell the assets at a fair value, or to lease them; or whether to carry out a complete liquidation to take advantage of the 15% capital gain provision. These are all difficult questions. The proper way is often difficult to find and a wrong choice can lead to trouble. But there often is a way, and if we are worth our salt a little difficulty may add zest to the game. It is also to be noted that in commencing operation as a partnership one does not irrevocably commit himself to this way of doing business. It is comparatively simple to change over from a partnership to a corporation—much easier than the reverse.

In the real estate field it is customary to have each piece of property owned by a separate corporation. The advantages of this modus operandi are obvious not only for localizing the liability on the mortgage bond but also to localize operating risks and losses. It has become increasingly difficult to limit liability on the mortgage bond in New York State as a result of legislation which has removed the distinction between instruments executed under seal and those which have not been so executed. At one time it was possible through the use of a "dummy" and an undertaking under seal to prevent the real owner of a piece of property from becoming personally liable on the bond. Thus, without the use of a corporation the desired protection could be secured. Under the old rule of law the creditor was precluded from holding liable the undisclosed principal on a sealed instrument and could only recover judgment against the party or parties on the instrument. With the sweeping away of the significance of the seal this protection has been ended and the creditor can hold the principal for whom the "dummy" is acting. Thus, the professional "dummy" has become a thing of the past and these intrepid gentlemen who boldly signed their names to undertakings of astronomical sums have gone the way of the wooden Indian. But let us pass from our grief over the passing of an ancient and honorable profession to the task of considering what is to be done to keep our clients free from liability on innumerable bonds and at the same time enable them to avoid the disadvantages of corporate taxation. Many attorneys believe that the use of a separate corporation for the signing of bonds is no longer effective to keep the transferring corporation free from liabil-

ity on the bond. The custom of property owners of transferring parcels out of an owning and operating corporation to another corporation which has no assets shortly before the raising or extension of a mortgage may be of no avail. As you know the property is retransferred shortly after the papers are signed.

Now, like the contestants in a six-day bicycle race, I have gone all around the circuit and am back at the starting point. I have counseled making less use of corporations and have shown further on that it is exceedingly doubtful if liability on the bond can be avoided except by the use of a separate corporation for each parcel. Thus, it would appear that I have refuted my own contentions. But what I have attempted to do is to present the full picture even though I may not have a solution. I should like, however, to point out that where property is purchased the buyer does not usually assume the mortgage. During the period until the mortgage is extended there is no bond liability on the part of the owner and individual operation can be carried on at least during that period. It is also noted that it is not possible to get a deficiency judgment in New York State today, regardless of the bid price at the foreclosure sale, unless the Court considers the property to be worth less than the amount due the mortgagees. In such case a deficiency judgment can only be secured for the amount by which the sum due the mortgagee exceeds the value of the property. Perhaps the best method of operation is to have the property owned by a corporation which leases it at a fair rental to the individuals involved. In such case the mortgages would be obligations of the corporation. The operating profits would accrue to the individuals who would thus enjoy the tax advantages of such operation.

It is sincerely to be hoped that the day will come when real estate loans will be made in the form of mortgages on the properties involved without any bond liability of any nature whatsoever. I understand that such is the custom in England. The present system does not result in the mortgagees recovering any consequential sums as the result of deficiency judgments awarded them. It simply saddles the mortgagors with extra expenses incurred in order to avoid bond liability. In the last analysis any expense borne by the mortgagor is eventually a disadvantage to the mortgagee.

It is also to be hoped that the Federal Government will see fit to remove the tax disadvantages of the small corporation as against individuals and partnerships. This may be the result as the trend away from incorporation becomes more general.

United States War Bonds and Stamps Are

THE BEST INVESTMENT

in the World Today

Accountants' Liability

By Saul Levy, C.P.A.

THE subject of accountants' liability is as broad as the scope of our professional activity and the content of the opinions which we issue in the course of our work. It involves our relations with the government, the general public, our clients, and with each other. This paper will attempt to deal with only one phase of the subject. It will discuss the question of legal liability from the standpoint of its intimate relation to the development by our profession of its own technical criteria.

During the past several years the American Institute of Accountants through its committees and its members has been dealing aggressively and effectively with accounting and auditing standards, procedures, principles and terminology. Insofar as these matters are crystallized into a form or formula which has the general approval or acceptance of the profession, we succeed in establishing technical criteria "by which facts, principles, opinions and conduct are tried in forming a correct judgment respecting them." This paper is presented from the viewpoint of those who believe it is the function of every profession worthy of the name to establish its own technical criteria. The desirability of doing so in its relation to the question of legal liability will be here considered.

In recent years, considerable attention has been focused on the dual responsibility of the client and the independent public accountant. Responsibilities arise simultaneously through the publication or issuance by the client of statements whereby the client makes certain representations concerning his financial position and operating results, to which statements is attached the certificate or opinion of the independent public accountant. In an effort to clarify the situation, members of our profession have raised the question "Whose Balance Sheet is it?" Many have strenuously insisted that it is the balance sheet of the client and that it sets forth the primary representations of the client. Others have pointed to instances where the public accountant himself prepared the statements, where the public accountant was engaged to do so, and where the credit grantor and others have regarded the resulting statement as the accountant's balance sheet.

A third viewpoint has been recently asserting itself which seems to carry us along a little further toward a clearer understanding of the respective responsibilities of client and public accountant. It is pointed out that certified financial statements are the statements both of the client and of the accountant.

Insofar as such statements set forth the financial position or the operating results of the client, they are obviously the statements of the client. The client assumes responsibility for the factual representations they contain and for the accuracy of the accounting records upon which they are based. He does not relieve himself of such responsibilities by engaging a public accountant to audit his records and to express an opinion concerning his statements.

In a different sense, the statements are at the same time those of the accountant. It is through the medium of these statements that the accountant expresses a professional opinion concerning the financial position and operating results of the client. The statement becomes an integral and inseparable part of the

Presented before the Annual Meeting of the American Institute of Accountants at Chicago, Ill., September 30, 1942.

accountant's opinion. That opinion may serve to support and tend to corroborate the representations of the client, but it does not involve the assumption by the accountant of responsibility for the factual representations of the client. From this viewpoint, it would seem to be immaterial whether the client or the accountant prepared the financial statements in the first instance. In either case, the accountant, in expressing an opinion concerning the statements, assumes responsibility for whatever opinion he expresses. The legal liability of the accountant for the expression of a professional opinion is governed by the nature of that opinion, and a finding (by whatever tribunal has the function of making such a finding) as to whether or not that professional opinion is reasonably well-founded in terms of auditing standards and procedures and accounting principles and terminology.

While the respective responsibilities of the client and the public accountant may arise out of the same financial statements, they are separate, distinct and different types of responsibility. If we speak of the primary responsibility of the client, we are in danger of implying that public accountants have a related secondary liability. This may put us in the undesired position of assuming secondary liability for factual representations, when we have done no more than express an opinion.

Since the *Ultramares* case, which was decided in 1931, we have given a great deal of thought to the fundamental distinction in our work between representations of fact and expressions of opinion. A representation of fact by the accountant is virtually warranted to be true. As was stated by the Court in the *Ultramares* case:

> "The defendants certified as a fact, true to their own knowledge, that the balance sheet was in accordance with the books of account. If their statement was false, they are not to be exonerated because they believed it to be true * * * accountants * * * by the very nature of their calling profess to speak with knowledge when certifying to an agreement between the audit and the entries."

In certifying to the statements with respect to the client's financial position or operating results, accountants usually profess to do no more than express an opinion. This is clearly indicated in the form of certificate, report or opinion now in general use by the profession. Nevertheless, an element of fact still remains in our certificates, though it relates to the scope of review or examination made, upon which our opinion is predicated. As Mr. Spencer Gordon stated at the 1939 annual meeting of this Institute:

> "If the form of report recommended by the special committee on auditing procedure is to be used it would appear that the only statements of fact will be as to the scope of the examination made. Under the doctrine promulgated by Judge Cardozo it would seem to follow that if the accountant has not *made* the examination that he states that he has made, he may be held in an action of deceit by any third party who has relied on the report, but the proposed form of report does not appear to involve any statement of fact as to the *result* of the examination. That the balance-sheet and the related statements of income and surplus fairly present the position of the company and the result of its operations is to be stated as a matter of opinion."(1)

(1) Spencer Gordon, Liability Arising from Accountant's Report (Papers on Auditing Procedure, etc. presented at the Fifty-second Annual Meeting of the American Institute of Accountants, 1939, page 53).

Any such factual representation concerning the scope of review or examination which has been made, is likely to appear in very general terms, leaving much to implication and exploration should controversy arise. The scope of the examination made is so essential a prerequisite for the expression of the opinion which is founded upon it, that from the standpoint of legal liability the examination and the opinion usually merge into each other. This becomes apparent when we consider some of the characteristics of the professional opinion of the independent public accountant.

The *Ultramares* case also drew a distinction between negligence and fraud. It held that whereas the negligence of the accountant might create liability to his client, it would not result in liability to a third party relying upon the accountant's opinion. At the same time, however, the Court held that there would be liability to third parties for the fraud of the accountant and that such fraud might grow out of the expression of an opinion. In this connection the Court stated:

> "Even an opinion, especially an opinion by an expert, may be found to be fraudulent if the grounds supporting it are so flimsy as to lead to the conclusion that there was no genuine belief back of it. Further than that this Court has never gone. Directors of corporations have been acquitted of liability for deceit though they had been lax in investigation and negligent in speech * * *. This has not meant, to be sure, that negligence may not be evidence from which a trier of the facts may draw an inference of fraud * * * but merely that if that inference is rejected, or, in the light of all the circumstances, is found to be unreasonable, negligence alone is not a substitute for fraud."
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> "Our holding does not emancipate accountants from the consequence of fraud. It does not relieve them if their audit has been so negligent as to justify a finding that they had no genuine belief in its adequacy, for this again is fraud."
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> "In this connection we are to bear in mind the principle already stated in the course of this opinion that negligence or blindness, even when not equivalent to fraud, is none the less evidence to sustain an inference of fraud. At least this is so if the negligence is gross."

The *Ultramares* opinion has been followed without modification in subsequent cases both in the New York and Federal Courts. It remains our leading authority on accountants' liability. Although it drew a distinction in principle between negligence and fraud, it also established the rule that negligence may be offered as evidence of fraud. In consequence, a jury may hold that an accountant's opinion is a fraudulent pretense, merely because, in that jury's judgment, the underlying audit or examination was grossly negligent. Whether there was such negligence, and whether such negligence was sufficient to sustain an inference of fraud, are questions of fact for the jury to decide. In four of the leading cases[2] relating to accountants' liability, beginning with the *Ultramares* case, our appellate courts have consistently recognized and upheld the right of juries to pass upon these questions. Where trial courts have ruled that there was not sufficient evidence from which a jury

[2] *Ultramares Corporation* v. *Touche* (1931) 255 N. Y. 570; *O'Connor* v. *Ludlum* (1937) 92 F. (2d) 50; *State Street Trust Co.* v. *Ernst* (1938) 278 N. Y. 104; *National Surety Corp.* v. *Lybrand* (1939) 256 App. Div. 226.

might find fraud and where a jury verdict adverse to the accountant has been set aside by a trial judge, the appellate courts have reversed the trial courts and have sent these cases back for new trials. On the other hand, where a jury, after listening to all of the evidence, has found the accountants free from liability, the appellate court has been unwilling to disturb that finding. The significance of this is that the question of liability in any litigated case is likely to be a question of fact to be passed upon by a jury of laymen. The jury will examine the opinion of the accountant, pass upon its meaning, determine whether the opinion was properly based upon adequate examination or whether it was so negligently conceived that its expression amounted to fraud.

Some of the characteristics of the professional opinion of the public accountant which may become issues of fact for a jury to pass upon are the following. It will be seen that each of these characteristics involves an evaluation of difficult technical matters concerning which most laymen have had no previous knowledge or experience.

Without attempting a definitive description or analysis thereof, it may be pointed out that the accountant's opinion is (1) a technical opinion, (2) an informed opinion, (3) an expert opinion, (4) a candid opinion and (5) an independent opinion.

1. It is a *technical* opinion. The conclusions of the accountant are presented in the technical form of the balance sheet, income or operating statement, surplus account and supporting schedules. The opinion relates to financial position in the accounting sense and does not purport to appraise the enterprise in its entirety or evaluate any of the fixed assets. It does not guaranty the accuracy of the client's representations of fact.

This technical aspect of the accountant's opinion is further indicated in the following comments:

> "Some important elements of financial position are altogether beyond measurement and statement in terms of money values. Other elements frequently involve judgments and approximations which may be formulated or made within comparatively wide areas of reasonableness. This is particularly true, as the committee pointed out, of income statements prepared to cover the short period of a single year where, in a going concern, many items of unfinished business exist at the close of the year and where the direction of long-term trends is not fully apparent.(3)
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> "As for the balance-sheet, the committee has a full realization of the wide-spread misconception of the document as a measure of value or present worth and has repeatedly pointed out that its basic function is to measure investment rather than value. The current studies on the use of the term 'surplus' seem to indicate an unfortunate association, in the minds of many, of surplus and value."(3)

2. It is an *informed* opinion. It is predicated upon an examination of the books of account, supporting records, system of internal control, tests of inventory, independent confirmation of facts recorded and such other examinations or tests as the accepted and established practices of the profession require. Such procedures and practices prescribe the minimum of examination to be followed. In many important respects, the amount of detail to be reviewed,

(3) James L. Dohr, Reflections on the Development of Accounting Procedures, Journal of Accountancy, July, 1942, pages 43 and 44.

as well as the choice of method, are matters of expert judgment within the discretion of the accountant.

3. It is an *expert* opinion. It is the work of one well trained for the particular task, who performs the prerequisite examination of accounts and the interpretation thereof in a competent manner.

The most frequently quoted statement of the general rule of law applicable to the rendition of expert services is the following:

> "Every man who offers his services to another and is employed assumes the duty to exercise in the employment such skill as he possesses with reasonable care and diligence. In all those employments where peculiar skill is requisite, if one offers his services, he is understood as holding himself out to the public as possessing the degree of skill commonly possessed by others in the same employment, and, if his pretentions are unfounded, he commits a species of fraud upon every man who employs him in reliance on his public profession. But no man, whether skilled or unskilled, undertakes that the task he assumes shall be performed successfully, and without fault or error. He undertakes for good faith and integrity, but not for infallibility, and he is liable to his employer for negligence, bad faith, or dishonesty, but not for losses consequent upon mere errors of judgment."(4)

The Chief Accountant of the Securities and Exchange Commission recently discussed this matter and stated:

> "The new rules ask for a positive representation as to whether the audit made was in accordance with generally accepted auditing standards applicable in the circumstances. The propriety of such a requirement, as opposed to a requirement merely for a statement of the accountant's opinion on the point, was the subject of a good deal of debate and was adopted only after full consideration of opposing views. As I see it, an unqualified certificate contains an implied representation that the accountant has lived up to the standards which are generally approved by his colleagues. Such a representation, indeed, is implicit, I think, to all professions —that one who holds himself out as a professional man represents that he has and has exercised that skill and knowledge common to his calling. The new rule merely makes explicit what was before implicit."(5)

4. It is a *candid* opinion. It sets forth its conclusions in such form that material factors are not concealed or suppressed. If the opinion is subject to any important mental reservation or if facts have come to the notice of the accountant which have an adverse bearing upon the conclusion reached, such negative factors are either set forth explicitly as qualifications, reservations or exceptions, or (in the judgment of the accountant) are so material that he refrains from expressing any opinion. In this connection, the following is quoted from the bulletin of the Institute on Extensions of Auditing Procedure (Statements on Auditing Procedure—No. 1, issued October, 1939):

> "In explanation of the general principles governing the auditor's opinion, with particular regard to explanations and exceptions, it is pertinent to state that the auditor satisfies himself as to the fairness of the statements 'by methods and to the extent he deems appropri-

(4) Cooley on Torts, 2nd Edition, page 277.

(5) William W. Werntz, Some Current Deficiencies in Financial Statements, Journal of Accountancy, January, 1942, page 27.

ate' in general conformity with the auditing procedures recommended in the Institute's bulletin EXAMINATION OF FINANCIAL STATEMENTS. Ordinarily, if he has so satisfied himself, he is in a position to express an unqualified opinion. However, if he considers it in the interest of clear disclosure of material fact to include explanations of procedures followed, he is free to do so. If, on the other hand, such disclosures are made by reason of any reservation or desire to qualify the opinion, they become exceptions and should be expressly stated as such in the opinion paragraph of the auditor's report. As previously stated, if such exceptions are sufficiently material to negative the expression of an opinion, the auditor should refrain from giving any opinion at all, although he may render an informative report in which he states that the limitations or exceptions relating to the examination are such as to make it impossible for him to express an opinion as to the fairness of the financial statements as a whole.

"It is desirable as a general rule that exceptions by the independent certified public accountant be included in a paragraph separate from all others in the report and be referred to specifically in the final paragraph in which the opinion is stated. Any exception should be expressed clearly and unequivocally as to whether it affects the scope of the work, any particular item of the financial statements, the soundness of the company's procedures (as regards either the books or the financial statements), or the consistency of accounting practices where lack of consistency calls for exception."

5. It is an *independent* opinion. It is an unbiased and disinterested opinion. The accountant impliedly represents that he has no conflicting interest which may raise a doubt as to his independence of judgment. This vital question of independence was recently discussed at some length by a former president of the Institute, who stated, among other things:

> "Evidently it has always been considered an attribute so indispensable to the public practice of accounting that it was taken for granted, and it never occurred to anyone to attempt to define it or to create rules requiring it."(6)
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> "Independence is the certified public accountant's stock in trade. He invites public criticism which may result in his professional disaster if he permits circumstances to arise which cast doubt on his independence, even though he may be sure that his state of mind is as independent as it could be. In this case the appearance of impropriety is only slightly less dangerous than the impropriety itself."(6)

Limitations of space and time prevent a more amplified discussion of the foregoing elements and characteristics of the accountant's opinion. It must be obvious, however, that any one of these elements may become a crucial issue which cannot be resolved intelligently without passing judgment upon one or more technical questions of accounting and auditing principles, procedures, practices, standards, conventions, precedents, rules, forms, definitions and the like. The conclusions and findings of juries will be based upon the evidence presented of what the accountant did and what he should have done. If our profession itself has failed to agree upon these matters, there is most likely to be a confusing conflict of expert testimony, raising controverted issues concern-

(6) Frederick H. Hurdman, Independence of Auditors, Journal of Accountancy, January, 1942, page 55 and page 60.

ing which juries will have the final word. On the other hand, to the extent that these technical matters are sufficiently clarified and established by the profession itself, it is likely that juries will accept the criteria of the profession and not impose upon us their own inexpert conclusions as to the accountant's duty in any given case.

There has already been reference to the fact that in four leading cases the appellate courts have indicated a consistent disinclination to disturb the findings of juries in cases involving the alleged negligence and fraud of accountants. Certainly that policy of the appellate courts will persist in situations where the existence or the content of professional criteria is seriously disputed. We have reason to expect, however, that if these matters are sufficiently clarified and established by the profession itself, courts of law will be placed in a position to set aside adverse jury verdicts as contrary to the weight of evidence when such verdicts are in conflict with recognized and accepted professional standards and criteria as testified to by experienced and reputable members of the profession.

Such clear-cut professional standards may be exacting in the matter of minimum requirements and in that way to some extent may restrict the free use of judgment on the part of the accountant. This fear has been picturesquely pointed up by one of our distinguished members in warning us that "it is easier to get into a straitjacket than to get out of it." Others have taken what is urged in this paper to be the more far-sighted view. An eminent expression of this latter viewpoint is the following quotation from a recently published article on Accounting Standards by Mr. Victor H. Stempf:

> "It follows that objective standards narrow the sphere of individual judgment and personal opinion as to what the standards are, but it does not follow that they restrict reasonably free judgment and individual opinion as to the propriety of applications of such standards. In respect of these the accountant's work must still be judged by what other competent accountants would have done under the same circumstances in conformity with the standards set by the profession. The immediate need is for the accelerated formulation of these objective standards."(7)

We owe it to our profession to guide and instruct its members in the performance of their important functions. We also have a duty to the public and to ourselves to enlighten all interested parties as to what is the technical nature of the services we render and what is the scope of the responsibility we assume in performing such services. These are paramount considerations. Furthermore, any standards or criteria which we establish are likely always to permit wide latitude for the exercise of expert judgment. Even if such latitude is not to be unlimited, any apparent disadvantage to us will be far outweighed by the sound protection afforded accountants in the face of threatened liability. Only through well-established professional standards and criteria can accountants assure themselves of judgment by their peers. The legal liability of accountants should be confined within the framework of *professional* standards and criteria. If that framework is not constructed by the profession itself, it will be rudely fashioned for us by juries of laymen out of the unfortunate material presented to them in the extreme situations which are occasionally litigated.

(7) Victor H. Stempf, Accounting Standards, Journal of Accountancy, January, 1942, page 67.

Control and Allocation of Expenses Under Abnormal Conditions

By DONALD M. RUSSELL, C.P.A.

THIS topic, the control and allocation of expenses, is one which suggests many different things to many different people. Entirely different pictures come to the minds of persons who may be operating standard cost systems and to those operating actual cost systems, to those dealing with commercial work, to those dealing 100 per cent with Government contracts and to those operating mixed commercial and Government production, to those starting new enterprises and to those having long established experience in cost standards and cost records. However, as was brought out in our meeting yesterday, we are all getting on somewhat common ground, due to the control of all of our economic life which has been assumed by the Government under these abnormal conditions.

Under the Executive Orders of the President (No. 9001, issued December 27, 1941, and No. 9127, issued April 10, 1942), Government officers have received very broad powers, both to re-negotiate contracts and to audit the books and records of all contractors and sub-contractors engaged in defense work under contracts entered into since September 8, 1939, so that our consideration of this topic is quite necessarily directed first to the Government interpretation of cost problems under war contracts.

I would like first to raise one or two questions which are of general accounting interest—the effect of the Government's definitions of cost, and the Government's conception of fixed fees, upon the general financial statements and their effect upon the determination of realized income available for dividends, to be reported to stockholders in the annual reports of corporations.

Financial Statements: We know that under the Government definitions we are permitted to include in cost, not only the usual manufacturing costs and expenses, but also a part of selling, administrative and general expenses. Ordinarily, selling, administrative and general expenses have nothing to do with inventory valuation; to put them into the inventories is to defer a part of these expenses to a future period. How do we stand if we value our inventories according to the Government definitions, from the viewpoint of being consistent with last year, and from the viewpoint of determining realized income?

It is very well to say that perhaps we can put these elements of cost into the inventories and then take them out again for the financial statements, but that may be a very difficult thing to do, particularly if we are required or desire to keep costs by individual parts. Some of the contracts call for parts' costs as well as total contract costs. I would suggest, in preparation for handling this question, that it would be a good idea never to lose sight of the total gross cost put into a Government contract, even though we bill out our costs every month on public vouchers. We may need to know the total gross costs, cumulatively, at every closing date, because we may wish to make an estimated

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adjustment to convert Government-interpreted cost back to what we usually think of as cost. If this adjustment is made it will probably have to be done by the use of an over-all or an approximated percentage.

I think it would be well also, in handling these contract costs, to remove from the contract cost accounts items which are temporarily in dispute and put them into a suspended cost account. That will serve two purposes—it will focus our attention upon doubtful items and it will also help us to keep the billings current. I believe some companies have already run into difficulties in having to make repeated analyses of open balances in contract cost accounts because of the differences between what they have charged into those accounts and what they have been able to "bill up" on public vouchers with the approval of the Government auditors. Therefore, I think it would be distinctly helpful to segregate disallowed items by classes in a suspense account for the purpose of keeping the record clean and keeping the unbilled balances current.

I am speaking about inventories as the proper term to describe unbilled costs on Government contracts. From some points of view perhaps the unbilled balances are accounts receivable. Under conditions where the Government takes title to all of the material, immediately upon disbursement of the funds, it may be that the costs incurred immediately become accounts receivable. However, in many cases, and particularly in smaller concerns acting as subcontractors, they must continue to handle these accounts as inventories, even though they are having to adopt Government interpretations of cost.

If a portion of selling, administrative and general expenses is to go into inventory, what is the proper treatment for the offsetting credit?

One method is to charge items directly out of selling, administrative and general expenses or to shortcut those accounts. If that is done, our selling, administrative and general expenses appear to be very much smaller than in the preceding accounting period, because part of them have gone directly over to the Government costs. Another method is to show the distributed amount in the selling, administrative and general expense section of the income account, as a special credit. Another way might be to show inventories of selling, administrative and general expenses at the beginning and end of the period, or to put into the income account the increase or decrease in the inventory of selling, administrative and general expenses includible in costs under the Government definitions.

All of these methods, however, result in getting that credit into the net income account, and reporting it as true income for the period; that is, income available for dividends. I suggest that we might give consideration to the procedure of crediting the item to a deferred account in the balance sheet and later adjusting that account by transfers to the credit of cost of sales proportionate to the transfers of the inventories to cost of sales.

The reason why that idea appeals to me, at least theoretically, will be shown also by considering the nature of the fixed fees. We get into the idea of thinking of fixed fees allowed under cost-plus contracts as being the income or the profit from those contracts. As a matter of fact, the fixed fees have to include most of what we usually call selling expense, and a considerable share of what we call administrative and general expenses, and under the interpretation of T. D. 5000, the fixed fees usually have to cover interest which we ordinarily class as an "other deduction" in our income accounts, and also has to cover the federal income and ex-

cess profits taxes. Thus, the fixed fees really are closer to the gross income in our profit and loss statement than they are to net income.

Government contracts provide for many ways of billing or collecting these fixed fees. Some of them provide that we may bill them proportionately to the public vouchers. In that case we may spend 50 per cent of our total cost for materials in the first month or two of the contract, and immediately bill to the Government and collect our fixed fee. If that fixed fee is then taken into the income account directly it appears that we are anticipating the realization of net income. We are probably taking it into our income account too early. Under these circumstances should not the fixed fees also be credited when billed to a deferred account in the balance sheet? The transfers of fixed fees plus the transfers of the credits for distributed selling, administrative and general expenses, at such times as shipments are made, would result in the recognition of realized income in a manner consistent with commercial practice. Of course, some contracts provide that the fixed fees may be collected upon shipments; that is more in step with commercial practice, and there perhaps would be no occasion in that type of procedure to use a deferred balance sheet account.

We should bear in mind, all through this talk, that, while I am basing most of it upon the Government procedures for cost-plus-fixed-fee contracts, our fixed prices are all subject to re-negotiation, and when we come to re-negotiate, the definitions of cost and the definitions of allowable profits are going to be the definitions of costs and fixed fees under the cost-plus-fixed-fee procedures.

Negotiated Flat Charges: We find frequently that negotiations have been made to avoid determining actual cost by using flat charges; for example, flat charges for purchasing and clerical expenses on construction contracts where general overhead expenses are not usually allowed. Flat charges may be applied to tool room orders in lieu of actual material, labor, overhead and profit, or we may find management fees for operating a Government-owned plant. If the amounts are incidental and no profit is intended, they may be credited to the expense accounts for which they have been substituted. If significant in amount, however, it appears that the distributions of expense should be based upon the gross amounts of expenses incurred. The resulting difference between the flat allowance and the actual cost of the service rendered should be closed direct to profit and loss. Section 26.9 of T. D. 5000 provides that no *loss* on another contract shall be included in cost. Neither should the *profit,* if any, be credited to cost. This procedure would, moreover, furnish information as to the adequacy of the negotiated flat rates for use in subsequent negotiations.

Standard or Normal Costs: Particularly where commercial work is continued along with war work, the contractor will be fortunate if he already has in operation long-term standard costs. It would be most unfortunate if concerns which have developed, over the years, reliable cost *standards* and standard *costs* should abandon them now.

The added volume of operations results in decreased fixed costs per unit of commercial product. From the point of view of the cost standard, this should be recognized as an abnormal and temporary condition, and the standards should not be revised downward for this reason. As pointed out by Mr. Lawrence Downie at the N. A. C. A. convention in 1940, such reductions in cost, if permitted to reduce *prices* of commercial products, would result in price structures that would be ruin-

ous to the particular industry after the termination of the emergency period. The variances should be analyzed in such manner as to segregate the component variances due to performance or changes in prices, from those due to increased volume. The volume factor is bound to result in favorable variances on commercial work which represent additional profit due to sharing the actual fixed or stand-by costs with the supplementary Government work, and this particular credit variance is a profit that belongs to the contractor. The Government also profits on its work by being charged a smaller share of the fixed costs on its contracts than it would sustain if it did not share the fixed charges with commercial work. If standard costs are applied in costing the Government work, the credit variances due to volume in excess of standard which are applicable to the Government work must be credited to the Government.

One exception may be noted, however, to the principle that savings from lowered costs on commercial activities due to increased total volume belong to the contractor. In the case of plant facility construction contracts, it is the theory of the Government that none of the fixed charges for the contractor's general expenses are to be included in the construction cost. That is another way of saying that the other operations of the contractor's business must continue to stand a normal overhead, it being assumed that the general overhead would have been incurred anyway, even if there had been no construction contract. This applies to executive salaries, corporate taxes, and most of the items we usually classify as administrative and general expenses. This exception appears to be imposed even if the other operations of the contractor have been discontinued by Government edict. The theory is that the contractor will make his profit on the supply contract to be performed after the construction has been completed.

Government auditors, usually, will agree to the temporary use of either standard costs or normal burden rates to expedite current reimbursements, and subject to later adjustment to actual costs. I believe it will be possible to arrange for such adjustments on an annual basis, on a long-term contract. The correction factors, undoubtedly, will need to be applied in some detail to achieve a reasonably accurate apportionment. It is doubtful, for example, that the apportionments between commercial work, fixed-price contracts, and cost-plus-fixed-fee contracts can be made on a factory over-all basis; the variances from normal burden rates, undoubtedly, should be departmentalized and traced back to the original charges to the limits of reasonable expenditure for clerical expenses. The variances should be related to the total costs incurred rather than to the charges billed; that is, credit variances should be disposed of with due regard to inventories.

In the absence of an elaborately developed standard cost system, with a completely established procedure for the analysis of the numerous factors which cause variances, it would appear that any standards or normals in use which result in unusually large variances on the war contract work should be promptly revised. The variances must be disposed of to the satisfaction of the Government auditors; if they are so great as to appear to destroy the reasonableness of the first cost computations, a great deal of difficulty with the Government auditors undoubtedly will result. Any computation for the disposition of the variances will be less accurately distributed than the first computations, otherwise the cost accounts would be entirely rewritten. This situation must be avoided by

close attention to the variances incurred from month to month.

Direct and Indirect Expenses: In the Government's prescribed treatment of expenses there is greater stress laid upon the determination and segregation of direct expenses than has been customarily used by industry. Government auditors dislike distributed indirect expenses and much prefer a large basis for distribution and low percentages of overhead. Under this point of view, the greatest possible proportion of the total pay rolls should be disposed of by direct charges; upon occasions the auditors have even gone to the extreme of requesting that executives salaries be charged direct. This general principle is not contrary to the best accounting practice, in fact, most cost accountants will agree that distribution of expenses from their source is to be preferred, wherever possible, to the pooling of expenses and distribution of the lump sum. The commercial rule that "direct expenses" may be treated as "indirect" if the costs of treating them as "direct" are unreasonably high, and if the difference in the end result is immaterial as compared with the clerical cost involved, should still prevail.

Under Section 26.9 of T. D. 5000 there are three tests of "direct" expenses:

1. They must be "properly chargeable" directly to the cost.

2. A detailed record must be kept by the contractor of all items of a similar character.

3. No item of a similar character which is properly a direct charge to other work may be included as a part of any indirect expenses prorated to the contract.

As the contracts uniformly refer to good accounting practice as the standard of accepted allowances of cost, we must rely upon that to interpret the first requirement that the items must be "properly chargeable" directly to the cost. There appear to be at least two approaches. The first is adequately described by the term "causal responsibility," as used by Mr. Harry Howell in his paper at the St. Louis N. A. C. A. convention in 1940. This approach is at the source of the expenditures; the other is at the receiving end and is the test as to what extent the contract received benefit. We must ask as to each item:

1. Did the contract cause the expenditure to be made?

2. Was the existence of the contract responsible for the expenditure?

3. Did the contract receive all of the benefit from the expenditure?

If the answers to these questions are in the affirmative and the tracing of the causal responsibility or benefit is complete as to the particular contract standing alone, the expenditure is a direct charge.

"Indirect" expenses are those of joint benefit to several contracts or lines of product and those expenses incurred for the business as a whole which are of some benefit to the Government. They exclude all expenses which have a direct causal responsibility or benefit to only one contract, and they exclude those expenses incurred for the business as a whole but which by Government definitions are unallowable elements of cost because they benefit only the corporate entity and do not benefit the Government. The Comptroller-General of the United States has the final word, and his opinions show a strict interpretation of what is "related to the contract." If no relation can be traced, the expenditures apparently fall within the class, "contemplated to be borne by the contractor." Every item to be included either in "direct" expenses or in distributed "indirect" expenses must have, in some degree, a relation of causal responsibility or of benefit to the contract.

In the revision of any cost system to meet the requirements of accounting for war contracts, the importance of adequate departmentalization of the plant can hardly be over-emphasized. If the Government production is in a completely separate plant, all of the expenditures at that plant have a direct relation to the contract, and there is little difficulty in proving the right to reimbursement. If the work must be carried on in a plant with commercial work, the greater the extent to which the Government work can be segregated in departments devoted 100 per cent to that purpose, the smoother the arrangements will work.

One difficulty arises before production begins in a plant where direct labor is the usual basis for overhead distribution. The same difficulty, also, is likely to arise towards the end of the contract period after production labor has been discontinued. Several months may elapse during which executives, engineers, purchasing agents, production-planning men and others may spend a great portion of their time on a new Government contract. Under the usual distribution of expenses, no charges could be made to the contract, because there is no productive labor on which to base the distribution. In this situation, those men, and all men of their service classification, should be requested to make daily time reports, so that the directly related services may be charged directly to the contract. Moreover, special cost studies should be made to determine burden rates to be added to the direct charges for their salaries, for these men use desk space, heat, light, elevator service and other services. Such special burden rates can well be computed by establishing the building or buildings in which the work is done as cost centers and arriving at a distribution of the total building costs based upon the pay roll for the entire building.

The requirement that if certain items customarily treated as overhead expenses are singled out for treatment as direct charges, then all items of a similar character must be so treated, causes some difficulties. It is a proper requirement. In practice, it has to be administered with reason, and frequently the resident auditors will agree that while many items have the same account classification in the books of account, they differ even within that classification, and there must be a residue that cannot be charged direct and which may be included in the distribution of the "indirect" expenses.

Segregation of Selling Expenses: Some concerns still carry, in their general accounts, two general divisions of expenses: manufacturing and commercial. The commercial expense controlling account is unsuited to present conditions whether operating fixed-price or C. P. F. F. contracts.

This account should be divided into two accounts for adequate control: (1) selling expenses, and (2) administrative and general expenses. As each of these groups, ordinarily, will contain certain unallowable expenses for Government contract accounting, it would be desirable to segregate the unallowable expenses under each classification in separate controlling accounts. All four accounts should be closed directly to the profit and loss account for general statement purposes but the two representing expenses allowable for Government contract accounting will be available for computing the necessary cost distributions. For cost accounting and Government inventory purposes, the allowable administrative and general expenses account may be distributed, as suggested in T. D. 5000, directly to contracts, on the basis of total manufacturing and installation costs incurred for the accounting period, i.e., usually the current month. The contracts, of

course, include all commercial, fixed-price and C. P. F. F. contracts or orders. Another method might well be to distribute to both manufacturing and selling operations, on the basis of total pay rolls under these divisions for the month. The allowable selling expenses, also, according to T. D. 5000, may be distributed directly to contracts and orders, either on a basis of sales completed during the period, or total manufacturing and installation costs during the period. If the total pay roll method has been used for the distribution of allowable administrative and general expenses, the allowable selling expense plus its pro rata portion of the distributed administrative and general expenses would be transferred to general manufacturing for further distribution.

Sales Branches: Many concerns being converted entirely to war production have extensive selling branch organizations. Attention is invited to the wording of T. D. 5000, which lists among the items which are excluded from the cost of performing a contract or subcontract, the "expenses, maintenance and depreciation of excess facilities (including idle land and building, idle parts of a building, and excess machinery and equipment) vacant or abandoned or not adaptable for future use in performing contracts or subcontracts." If branch plants are adaptable to and are being converted to war use, it appears that the expenses, maintenance and depreciation of such facilities should be included in the allowable selling expenses and distributed with other expenses of a general nature over all of the production of the concern.

Idle Plant Facilities: Aside from the problems of selling branches, we may have manufacturing facilities which are clearly to be excluded in our distribution of expenses. It appears evident, in addition to the quotation just given, that in respect to all permitted distributions of indirect expenses, all elements of expense therein must be "properly incident to and necessary for the performance of the contract," or again, from paragraph (j) in Section 26.9 of T. D. 5000 "all items which have *no relation* to the performance of the contract or subcontract shall be eliminated from the amount to be allocated." The wordings of these definitions, and the published opinions of the Comptroller-General indicate that *losses* of the contractor, as distinguished from costs and expenses of the contractor in connection with facilities needed for the contract or of present or future benefit to the Government, are not contemplated to be includible in Government costs. In other words, it does not appear that the Government intends to underwrite or subsidize the fixed charges which the contractor may have as a result of his capital investment in plant assets not suitable for war use any more than it subsidizes the small concern that may be forced by war conditions to go out of business. If it becomes necessary, as a part of the conversion of a plant to war use, to place certain machinery and equipment under tarpaulins out in the yard until after the emergency, such machinery should be segregated in the accounts and its carrying charges should be omitted from the cost computations. If, on the other hand, the machines can be converted to war use, and are expected to be so converted, they constitute *stand-by equipment,* and the carrying charges should be claimed in the overhead distribution accounts.

Depreciation and Amortization Allowances: One question that arises is whether we are bound to the same depreciation allowances permitted by the Treasury Department. Every case, of course, stands by itself. If our depreciation for tax purposes is based on corporate cost of the assets,

and if our tax return rates of depreciation, applied over the years, have resulted in net asset values that are fairly representative of the remaining useful lives of the assets today, there would appear to be no reason why the same computations, permitted by the Internal Revenue Code should not be acceptable for cost purposes.

It appears to be generally recognized, however, both by the Treasury Department and the business public, that many depreciation schedules, particularly those resulting from cumulative computations over a long period of years have become quite distorted from present facts. During the 1920's many concerns were overgenerous in depreciation allowances, and sometimes these rates were even carried through the depression years. For the past six years or more, the Treasury Department has been consistently reducing the allowed depreciation rates, in many instances basing the allowances upon the idea that the accumulated reserves should not be allowed to rise above some set limit, thus obviously understating depreciation allowances *currently*, to even up for too generous allowances *years ago*.

It appears to me that a contractor finding himself in this position with the Treasury is entitled to a fresh start when dealing with the War Department or the Navy Department. The cost determined for Government contracts may run but a short period relative to the lives of standard equipment converted to war use. The contractor is entitled to recover whatever is the actual cost due to wear and tear, obsolescence and other factors during the period of his contract. If a contractor had written his property account down to one dollar, or if all of his property had become fully depreciated, there would be no question of his right to restate his property accounts in order to compute the depreciation sustained on the war work. By the same rule, he should be permitted a fresh start if his asset and depreciation reserves are materially out of line with the present useful condition of the property. Taxwise, since income taxes appear to be here to stay, a taxpayer gets his depreciation either in one year or another, but the period of the war contracts will, we hope, not be sufficiently long to guarantee the contractor this protection.

Is accelerated depreciation an allowable element of expense in war work?

T. D. 5000 provides, as an allowable element of cost, that "In making allowances for depreciation, consideration shall be given to the number and length of shifts."

The E. P. F. and D. P. C. contracts for Government financing of plant facilities provide options to the contractors for purchasing the facilities at original cost less allowances for depreciation after the termination of the emergency. These option clauses quite uniformly state the following annual depreciation rates (which are higher than rates ordinarily used under normal conditions) to be used in determining the recovery purchase prices under these contracts:

Buildings and improvements	5 pct.
Machinery, equipment, furniture and fixtures	12 pct.
Portable and durable tools and automobiles	50 pct.

Section 8.2404 of the Navy Department regulations for the "Procurement of Naval Supplies" includes the following comment concerning accelerated depreciation as an element of the cost of supplies:

> Where plants are operating on two shifts, the depreciation rate may reasonably be 150 per cent of the normal rates for a single shift. Where the plant is operating on three shifts, the depreciation rate may be extended to 200 per cent of the normal rate.

Quite obviously, then, we have official sanction for the *principle* of accelerated depreciation.

Several points may well be borne in mind on this question:

1. The combined costs of maintenance and depreciation should be considered together. Excessive wear and tear may be made good during the accounting period by excessive expenditures for repairs and maintenance.

2. If the normal rates previously in use for the depreciation computations included a substantial allowance for obsolescence, supersession or inadequacy, a considerable amount of additional wear and tear may be experienced before any adjustment of the rate is in order. For example, if a machine could be used for 20 years on a wear and tear basis, but because we expected to want a larger or better machine in 10 years, we were using a 10 per cent rate instead of 5 per cent, then the machine can receive double the use without warranting any increase in the rate of depreciation. The 10 per cent rate then becomes 10 per cent for wear and tear rather than 5 per cent for wear and tear and 5 per cent for inadequacy, with no increase in the total charge to cost.

3. The same machines may have quite different life histories in the hands of different owners. Some factors to be considered, other than the mere number of hours of machine use, are (1) the frequency of inspection of the condition of the machines, (2) the speed-up over the designed r.p.m., (3) possible overloading in excess of the designed load, (4) the use of unskilled operators, and (5) rapid deterioration when ordinary maintenance is omitted due to the pressure of production.

What about amortization as an element of cost? This question may be of great importance to a contractor if the emergency plant facilities have been provided with the contractor's own capital, particularly if he operates under a cost-plus-fixed-fee contract. It has been clearly shown to be a policy of the Government not to permit special amortization of emergency plant facilities as an element of cost. This policy was explained a year or more ago to be (1) an effort to prevent inflation by keeping down the prices of the things the Government had to purchase that would be made in special war plant facilities, and (2) an effort to prevent alleged mistakes made in World War I, whereby the Government, by paying prices for supplies, which prices permitted the contractors to recover their capital investments, made so-called "gifts" to industry of valuable plant facilities.

The Administration developed the so-called tax-compromise idea, whereby contractors were permitted amortization for tax purposes, thereby recovering a part but not all of their capital investment through a reduction in taxes, but were not allowed recovery of special plant investment in excess of normal depreciation in the price of their products sold to the Government. This tax compromise was enacted into legislation in Section 124(i) of the Revenue Act of 1940, which required Certificates of Government Protection and Certificates of Non-Reimbursement to put teeth into the policy. This section proved, however, to be such a bottleneck to the war production program that it was repealed.

How does the situation stand today? Evidently we have fallen back upon the general provisions of law and Government contract regulations.

It should be recalled that prior to the advent of O. P. A., the War and Navy Departments considered amortization of special facilities a proper element of cost and they

established a procedure for guaranteeing such protection by special negotiation. It is noted also that Section 8.2404 (c) (8) of the Naval Regulations for the "Procurement of Naval Supplies" provides that amortization may be allowed as an element of cost where the purchases of special machinery and equipment have been approved in advance by the Navy.

The Treasury Department opposed the enactment of the amortization sections of the Internal Revenue Code on the argument that the ordinary depreciation, obsolescence and loss of useful value provisions gave the contractors ample right to recover the full costs of their investments for tax purposes. The difficulty there was that the deductions could be taken only *after* the event of the loss had taken place, and that current allowances to provide against the probability of the loss were denied. Treasury interpretations of the word "obsolescence" as an allowable element of cost under T. D. 5000 express the same view.

It is presumed that the auditors for Government contracts are still influenced by the same policy which brought about the enactment of Section 124(i). It may be that many contractors can recover all they consider necessary by means of accelerated depreciation. There may be instances, however (such as, for example, a shipyard constructed with private capital, the use of which for the entire period of the normal wear and tear life of the assets may be very problematical) where the actual cost to the contractor will not be determined unless an amortization allowance is included. The burden of proof, undoubtedly, will rest heavily upon the contractor; however, a claim should be made and a cost-plus-fixed-fee contract should not be closed until the facts are determined, even if it is necessary to hold the matter open until after the emergency to obtain a retroactive view of the facts.

Bases for the Distribution of Manufacturing Expenses: Section 26.9 of T. D. 5000 states that distribution on the basis of direct labor charges will be satisfactory, but that other bases may be used, depending upon "all the facts and circumstances." If better methods have been in use they should be continued. Special cost studies may frequently be required in order to produce evidence to the Government auditors that rates used for handling charges, floor space computations for departmental distributions, or power-plant schedules long in use are accurate under present operating conditions. The established methods may be sound in principle, but, in view of the frequent redepartmentalizations, reclassifications of expenses and conversions from commercial to war production, such established methods or schedules may very likely need review.

If the interpretations of direct and indirect labor are modified by the considerations previously discussed, the larger amounts classified as direct labor will require prompt reduction downward of normal departmental burden rates.

If service department costs (for example, power expense) have been distributed in two parts, (1) charges for fixed or stand-by costs allocated on a designed capacity or "ready for use" basis, and (2) charges for the variable factors of the service department costs (that is, the service actually used basis) there would appear to be every reason to continue this practice. The facilities inherited by the converted plant may bear little relation to the facilities that would be redesigned and installed today. Nevertheless, they are the actual facilities in use for the war production. The distribution of the total fixed service department plant in-

vestment costs should be revised according to present department utilization and the present machine requirements, but it would appear to me, under the actual cost theories, no segregation for capacity in excess of present needs would be required. In other words, the Government may have inherited a power plant which is not well designed or not economical for the use being made of it today, but the total actual costs may be applied.

"Reasonable" Expenses: Somewhere in every Government contract, there will be found the word "reasonable" in relation to allowable expenses. The interpretation of this word has been a shock to many executives. Apparently the interpretation is very different under a peacetime free enterprise, competitive economy, wherein a court may consider that compensation in excess of $1,000,000 a year is not unreasonable for top executives of a giant corporation, because of the competition for men of such caliber, as compared with a wartime, planned and "total-war" economy, under which citizens are being drafted regardless of personal abilities for military service at $21 per month.

I understand that the Navy and the Air Corps have established upper limits of $25,000 a year for executive salaries to be included in costs; that the Navy regards $9,000 a year as the top salary for field construction work; that the Ordnance Division of the Army requires special approval for salaries in excess of $12,000 a year; that bonuses are permissable only to the extent of 10 per cent upon salaries up to $3,000 a year, and that bonuses to executives are considered to be "not related to the contract" and "expenditures to be borne by the contractor out of his fees." Such limitations are not entirely new, as, I believe, the Merchant Marine Act of 1936 limited executive salaries, in the costs of contracts entered into by the Maritime Commission, to $25,000 a year.

We encounter similar interpretations of the word "reasonable" in the allowed per diem rates for traveling expenses. These rates as permitted by the Air Corps were $10 per diem for executives and $6 per diem for others, until late in 1941 when they were increased to $15 and $8, respectively.

The War and Navy Departments, also, insist upon the advantage of the Government rates (generally 60 per cent of commercial rates) on telegraph services. Each contractor must clarify his position with respect to this ruling. In certain instances, arrangements have been made to have separate invoices submitted by the telegraph companies for services on the Government contracts, and these invoices are paid directly by a Government Disbursing Officer after certification by the contractor, and they are thus excluded entirely from the contractor's accounts and costs. Under a Navy Department ruling, the 60 per cent limitation on telegrams applies only on "direct" charges and does not apply to telegrams included in "indirect" expenses prorated to a contract.

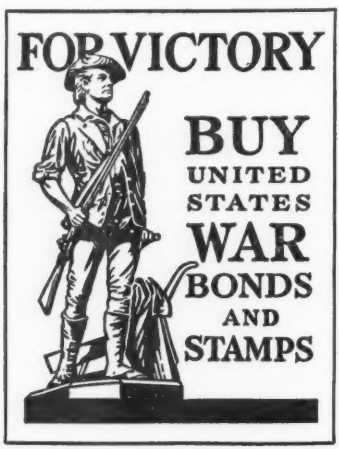
Contractors should protect their rights under their contracts in respect to all arbitrary limitations of expenses, by *written* protest or notice. In order to expedite current settlements, such excess expenses should be omitted from the expense distributions by segregation into an Unallowable or Suspended Expenses Controlling Account, supported by detailed schedules for future reference. Needless to say, such controlling accounts should not be used in computations of inventory valuations and they should be closed into the profit and loss accounts at each closing date. A permanent record should then be retained for future reference.

It is only fair to state that the Government, on cost-plus-fixed-fee

work, does permit the inclusion of certain costs which a commercial customer might consider unreasonable, e.g., the cost of training employees in the necessary skills to perform their work, the cost of spoiled and wasted work, reworks, advances in labor and material costs due to general price trends, and other items which, under the theory of "actual cost," are directly related to the contracts.

"Personal" Expenses: The opinions of the Comptroller General have disclosed a very restricted interpretation of the term "personal" expenses. For example, the cost of a chauffeur's license paid for an employee to permit him to drive in connection with his employment, the cost incurred by a contractor for employees while they were traveling on company business to assist them to obtain birth certificates required by federal regulations for admittance to other plants on business for their employers, and similar expenditures to assist them in filing questionnaires with draft boards, have been held to be personal to the employees and unrelated to the Government contracts, even for inclusion indirectly in general overhead expenses. It does not seem to me that a classification of "personal" expenses as unallowable expenses is sound, since the motivating force behind these expenditures, when made by the contractor, is the performance of the contract, and, moreover, Section 26.9 of T. D. 5000 specifically permits many "personal" expenses such as welfare expenses, pensions, traveling expenses, and, one might add, even pay rolls.

Contractors should not only reserve their legal rights by written notices to the contracting officers in connection with disallowances such as these, but they should make active protests, written and oral, so that interpretations may, if possible, be brought more into line with the usual business practices that were in the minds of the contracting parties when the contracts were signed.



SECURITIES AND EXCHANGE COMMISSION

ACCOUNTING SERIES Release No. 35, September 3, 1942

The Securities and Exchange Commission today made public an opinion of its Chief Accountant in its Accounting Series relative to the disclosure to be given to certain types of provisions and conditions that limit the availability of surplus for dividend purposes. The opinion describes some of the more common restrictions of this kind and outlines the necessary disclosure in financial statements filed with the Commission.

The opinion, prepared by William W. Werntz, Chief Accountant, follows:

"Inquiry has been made from time to time as to the necessity of disclosing, in financial statements filed with the Commission, provisions and conditions which in the particular case materially limit the availability of surplus for dividend purposes. The following are characteristic situations:

"1. Treasury stock has been acquired.

"2. Dividend arrearages exist on cumulative preferred stock.

"3. The preference of preferred shares upon involuntary liquidation exceeds the par or stated value[1] of such shares.

"4. The provisions of a trust indenture or loan agreement permit dividends on common or preferred stock to be paid only from earnings accumulated subsequent to a specified date or if surplus exceeds a certain amount.

"5. The provisions of a trust indenture or loan agreement prohibit the payment of dividends when such payment would reduce the margin of current assets over current liabilities below a stated minimum.

"6. The articles of incorporation require that an amount equivalent to a certain percentage of the par value of the greatest number of preferred shares outstanding at any one time is to be set aside semi-annually out of surplus or net profit before dividends may be paid on common stock.

"7. A loan agreement provides that dividends may only be paid after securing the consent of the lender.

"8. An order or requirement of a regulatory agency having jurisdiction limits the right to declare or pay dividends.

"In my opinion, generally accepted and sound accounting practice requires the disclosure of these and similar restrictions on surplus.[2] Otherwise, an erroneous impression is likely to be given the reader of the financial statements. Since Rule 3-06 of Regulation S-X provides that

> " 'The information required with respect to any statement shall be furnished as a minimum requirement to which shall be added such further material information as is necessary to make the required statements, in light of the circumstances under which they are made, not misleading,'

it is clear that in all statements filed with the Commission appropriate disclosure of material restrictions on surplus should be made.

"Minimum disclosure, in my opinion, would consist of a description of the restriction, indicating briefly its source, its pertinent provisions, and, where appropriate and determinable, the amount of the surplus so restricted. Such disclosure should be made either in a note to the balance sheet or in an appropriate place in the surplus section of the balance sheet. Also, any statement of surplus, such as is prescribed in Rule 11-02 of Regulation S-X, should contain similar information or should refer to the disclosure made in the balance sheet. Since the declaration and payment of dividends depends on many factors, other than the mere absence of restrictions of the type under discussion, disclosure pursuant to the above requirements should not be made in such a way as improperly to leave an inference that dividends will or may necessarily be declared from surplus in excess of the restrictions noted."

[1] Cf. Rule 3-18 (d) (3) of Regulation S-X, and also Accounting Series Release No. 9 which requires that in most cases an opinion of counsel be given as to whether this condition constitutes a restriction on surplus.

[2] Cf. American Institute of Accountants, Examination of Financial Statements (1936), p. 29.

ELECTIONS

THE following is a list of applicants admitted to membership, and associate membership in the Society and also associate members advanced to membership at the meeting of the Board of Directors held on September 17, 1942:

Membership

Ackerman, Samuel L., 136 East 57th Street,
Babeuf, Richard Burr, 90 Broad Street, With Lybrand, Ross Bros. & Montgomery.
Bottger, Frederick H., 704 Chamber of Commerce Building, Syracuse, N. Y. With John P. Carrigan.
Burston, Harry L., 11 West 42nd Street,
Carneol, Irving B., 1450 Broadway, Of Joseph N. Tropp Co.
Church, Frank John, 350 Madison Avenue, With Hurdman and Cranstoun.
Deitz, William, 51 Madison Avenue, With Aronson & Oresman.
Denby, Preston Hamilton, With U. S. Army.
Fliegel, Emanuel, 50 Broad Street,
Fried, Jacob Irving, 11 West 42nd Street, Of Shuster & Fried.
Gelbaum, Alfred H., Sylacauga, Alabama, With War Department, Alabama Ordnance Works.
Greene, George, 185 Montague Street, Brooklyn.
Harris, Justin Cecil, 21 West 86th Street.
Hull, Everett Leo, With U. S. Navy.
Kahn, Joseph V., 57 Market Street, Poughkeepsie, N. Y., Of Clark, Furness & Co.
Kraft, Ural S., With U. S. Army.
Metz, Nathan, 1440 Broadway.
Morris, Philip, 551 Fifth Avenue.
Patterson, Arthur W., III, 103 Park Avenue, With Davies and Davies.
Peretz, Jules, 521 Fifth Avenue, With Eisner & Lubin.
Platkin, Isidore, 565 Fifth Avenue, Of Tunick & Platkin.
Pollack, Benjamin, 21 West Street, With Supervisory Cost Inspector, U. S. Navy.
Price, Irving I., 1450 Broadway, Of Price & Lenley.
Rasmuson, Elmer Edwin, 67 Wall Street, With Arthur Andersen & Co.
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Ress, Warren Leonard, 21 West Street, With Supervisory Cost Inspector, U. S. Navy.
Rimerman, Samuel David, 565 Fifth Avenue.
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Sands, Philip, 8 West 40th Street, With Lerer & Lerer.
Seaver, Sydney, 521 Fifth Avenue, With Homes & Davis.
Slane, Harold C., 25 West 43rd Street, With Phagan, Tillison & Tremble.
Spilky, Leon, 51 Chambers Street.
Sternberg, Harry, 1776 Broadway.
Swedlow, Morris, 60 East 42nd Street, With Klein, Hinds & Finke.
Wagner, Meyer M., 17 John Street.
Wallace, Ralph Lane Polk, 1328 Broadway, Of R.L.P. Wallace & Associates.
Weinberger, Oscar, 285 Madison Avenue, With Jacobson, Greenfeld & Co.
Zwicker, Charles H., 11 Broadway, Of Samuel Shedler & Co.

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Easton, Kermit, Eddystone, Pa., With War Department, Philadelphia Ordnance District, Eddystone Suboffice, c/o Baldwin Locomotive Works.
Gould, Sidney, 125 Park Avenue, With S. D. Leidesdorf & Co.
Groff, Merlin L., 400 University Avenue, Rochester, N. Y.
Horn, Robert Henry, 200 Plandome Road, Manhasset, N. Y.
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Kaplan, David A., 774 Gates Avenue, Brooklyn.
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Schutt, Edward Andrew, 214-218 Main Street, Buffalo, N. Y.,
With Buffalo Evening News.
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With College of City of New York.
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Sturla, Cornelius A., Jr., 40 East 45th Street,
With James P. Silo.
Wiegard, Bernard, 590 Madison Avenue,
With International Business Machines Corp.
Zeizel, Leo A., 383 Madison Avenue,
With Market Administrator of the New York Metropolitan Milk Marketing Area.
Zupnick, Alex, 60 East 42nd Street,
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Advancement from Associate Membership to Membership

Astor, Maurice D., 401 Broadway,
Comptroller, De Lisser Machine & Tool Co.
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Barrett, Joseph F., 18 East 48th Street,
With Harris, Kerr, Forster & Company.
Borenstein, Hyman,
With U. S. Army.
D'Aleo, Hugo Edward, 60 East 42nd Street,
With Wilfred Wyler.
Danzig, Joseph, 29 Broadway,
Edmonds, Earl R., 295 Fifth Avenue,
With A. & M. Karagheusian, Inc.
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Flaster, Milton, 2 Lafayette Street,
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With U. S. Treasury Department.
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Glaser, Milton, 60 East 42nd Street,
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With N. Tannenbaum & Co.
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With Gray, Scheiber & Company.
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Johnson, Chester Philip,
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Kandt, Robert W.,
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With Resident Cost Inspector's Office.
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Schweig, Edwin Stephen, 51 Chambers Street.

Slater, Alexander E., Elkton, Maryland,
With Navy Dept., Office of the Cost Inspector, Triumph Explosives, Inc.
Sohmer, Leonard, 19 West 44th Street,
With George M. Sachs and Company.
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With Boyce, Hughes & Farrell.
Taylor, Jerome Harold,
With U. S. Army.
Wanderman, Herbert S.,
With U. S. Army.
Warantz, Joseph, 1440 Broadway,
With John S. Fogel.
Washburn, Earle L., 92 Liberty Street,
With Chambellan, Berger & Welti.
Waxman, Albert,
With U. S. Engineer Dept.
Weinman, Benjamin C., 90 Broad Street,
With Lybrand, Ross Bros. & Montgomery.
Weisman, Norman J., 47 West 34th Street,
With Grossman & Glitter.
Widerkehr, Abraham Andrew,
With U. S. Army.
Wiener, Robert Alvin, 18 East 48th Street,
With Daniel Nachbar.
Wood, John Francis,
With U. S. Navy.

The number of members in the Society as of October 1, 1942, is as follows:

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Associate Members..	436
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Authors of Articles In This Issue

BENJAMIN J. ELSON, C.P.A., LL.B., author of **"Why a Corporation?"** was graduated from Pace Institute, and later from St. John's College, School of Law, with a degree of LL.B. He has been a member of the Society since 1936, and was Chairman of the Committee on Real Estate Accounting from 1941-1942, on which Committee he has served since 1937.

SAUL LEVY, C.P.A., LL.B., author of **"Accountants' Liability"** was graduated from the New York University School of Commerce, Accounts and Finance in 1916 with the degree of B.C.S., and from the Brooklyn Law School of St. Lawrence University in 1921 with the degree of LL.B. He is a certified public accountant of both New York and New Jersey. Since 1919 Mr. Levy has engaged in general practice as a certified public accountant in his own office in New York City. In 1922, he was admitted to the Bar of the State of New York. For the past ten years he has served many of the largest law firms of New York City as consultant in accounting matters relating to financial litigation. In this connection, he has participated in three of the leading cases involving questions of accountants' liability, viz., the Ultramares case, the State Street Trust Co. case, and the case of O'Connor *vs.* Ludlum. Mr. Levy has been a member of the Society since 1916, and during that time served as a director for five years, was second vice-president last year, and is first vice-president this year. At the present time he is serving as expert consultant in accounting and legal matters to the Accounting and Audit Supervisory Branch, Fiscal Division, Headquarters, Services of Supply, War Department.

DONALD M. RUSSELL, C.P.A., B.S., author of **"Control and Allocation of Expenses under Abnormal Conditions"** is a partner in the firm of Lybrand, Ross Bros. & Montgomery in their Detroit office. He was graduated from Worcester Polytechnic Institute in 1913 with the degree of B.S., and after graduation he was engaged in engineering research and graduate studies at Worcester Polytechnic Institute and at the Westinghouse Electric and Manufacturing Company at East Pittsburgh, Pennsylvania. Mr. Russell taught mathematics for one year at the Worcester Trade School and for one year at Worcester Polytechnic Institute and received the graduate degree of Electrical Engineer from the latter institution in 1916. During 1916-1917 he attended the Harvard Graduate School of Business Administration, and in March, 1917, entered the Pay Corps of the United States Naval Reserve Corps. Mr. Russell received his C.P.A. certificate in Pennsylvania in 1923. He is a member of the Pennsylvania and Michigan state societies, the American Institute of Accountants, and many chapters of the National Association of Cost Accountants. Since 1940 he has given many talks to N.A.C.A. chapters on the general subject of Accounting for War Contracts.

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